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Understanding the Sale of "Property on Ground Lease"

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"Property on ground lease" is among the most confusing phrases, even to commercial real estate brokers. When you see a sale of "property on ground lease", it could mean:

1. Sale of land only. In this case, the building owner is the tenant, e.g. Burger King that has a business in the building. The tenant typically signs a 10-20 years absolute NNN ground lease with the landowner to lease the parcel. Should the tenant not renew the lease or be in default of the lease by not paying rent, the building with substantial value is reverted to the landowner. The tenant will make every effort to pay rent to avoid losing the building to the landlord. And so the cap rate for this property is about 1-2% lower than a property with both land and building. There are a couple of possible scenarios that could lead into a land sale only:
   - The business owner, e.g. a Burger King franchisee, could own both land and building originally. He then structures the sale of land only to an investor and then leases it back. He receives the tax benefits of being able to depreciate 100% of the building and fixtures. The tenant could later sell his interest in the building without the land to another investor and lease back the building.
   - The Landowner with no development expertise and/or financial resources asks the tenant, e.g. Burger King, to construct the building. The tenant pays for the construction costs and signs a long term lease for the lot. The landowner later sells the land to investors when he needs money.

2. Sale of building only. There are 2 separate leases in the property:
   - A building lease between the business owner, e.g. Burger King and the building owner, i.e. investor. In this lease, the business owner is the tenant and the building owner is the landlord. This lease is just like any typical leases.
   - A ground lease between the building owner and the landowner to lease the land. In this ground lease, building owner is the tenant and the landowner is the landlord. The building owner receives the rent from the business owner, and in turn uses a portion of that rent to pay the landowner for using the land.

It is important for an investor to understand some various aspects that involve "property on ground lease". To get a sense of this, consider the following:

1. How do you verify what you buy? If land is for sale, the title report shows "fee simple". The lease or another recorded document, e.g. development agreement, says the tenant owns the building. If building is for sale, the title report shows "leasehold estate".
2. How do you determine the property taxes? The property taxes bill divides the assessment into 2 portions: land value and improvement value. The landowner will pay the property taxes share based on the land value while the building value will pay the improvement value.
3. How do determine who owns what in county record? The county record only shows the name and address of landowner and does not show the name of the building owner. And so it's not easy to tell if the improvements have a separate owner.
4. What are the landlord's responsibilities? There are normally no landlord responsibilities if you only own the land. In the building only sale, there is a separate lease building owner and business owner. This lease will spell out landlord's responsibilities, if any.
5. What happens to the building when the ground lease expires or tenant is in default? The ground often has a provision that the building is reverted to the landowner when this happens. This means the building's interest is gone and the landowner then becomes the building owner.
6. Is it easy to sell your interest if the lease has a few years left? If you own the land, your interest may be hard to sell, but still sellable. Once the ground lease expires, the building owner owns nothing. As a result, this can make it quite challenging to find a buyer for the building.
7. Tax write-off's: Land does not depreciate for income tax purposes. The building, on the other hand is 100% depreciable.
8. Financing: if you buy the land portion, you should be able to obtain 65% LTV financing in today's market, just like a typical property with both land and improvements. However, it's very difficult to get financing for the building acquisition, especially when the ground lease has less than 20 years left.

Therefore, when you see a "property on ground lease" for sale, make sure you know what you are buying, considering there are many factors involved that can adversely impact/contest an investor's decision. If you're contemplating on buying the building without the land, think twice and make sure you have a clear understanding of all the plusses/minuses involved in this decision.